(4)

Supreme Court, U.S.
FILED
SEP 24 1996
CLERK

No. 96-235

In The

Supreme Court of the United States

October Term, 1995

FRANCHISE TAX BOARD OF THE STATE OF CALIFORNIA,

Petitioner,

v.

STEPHEN B. MACFARLANE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

REPLY TO RESPONDENT'S BRIEF

DANIEL E. LUNGREN,
Attorney General of the State of California
TIMOTHY G. LADDISH,
Assistant Attorney General
CAROL H. REHM, JR.
Supervising Deputy Attorney General
ANTHONY SGHERZI,
Deputy Attorney General
(Counsel of Record)
300 South Spring Street
Los Angeles, California 90013
(213) 897-2488

Attorneys for Petitioner

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

10 pl

TABLE OF CONTENTS

Page

TABLE OF CONTENTS i

TABLE OF AUTHORITIES ii

ARGUMENT 1

I. RESPONDENT'S OPPOSITION CONTAINS INACCURACIES WHICH NEED TO BE CORRECTED 1

II. THE CONFLICT WITH THE FOURTH CIRCUIT'S DECISION IS NOT DISPELLED BY THE FACT THAT THE FRANCHISE TAX BOARD WAS UNABLE TO MAKE A FINAL ASSESSMENT OF MACFARLANE'S TAX LIABILITY BEFORE COMMENCEMENT OF THE BANKRUPTCY CASE 4

III. A DEBTOR IN POSSESSION OR A TRUSTEE IS ALREADY REQUIRED TO POSSESS RECORDS SUPPORTING THEIR FINANCIAL TRANSACTIONS; NO CHAOS WILL RESULT BY REQUIRING THAT THE DEBTOR OR TRUSTEE COMPLY WITH EXISTING LAW AND PROVIDE EVIDENCE CONSISTENT WITH THE PROPER BURDEN OF PROVING ENTITLEMENT TO A DEDUCTION 5

CONCLUSION 7

TABLE OF AUTHORITIES

Page

CASES

California State Board of Equalization v. Official Unsecured Creditors Comm. (In re Fidelity Holding Co., Ltd.), 837 F.2d 696 (5th Cir. 1988) 2

In re Davidson, 156 B.R. 600 (Bankr. Ark. 1993) 5

Landbank Equity Corp. (Internal Revenue Service v. Levy), 973 F.2d 264 (4th Cir. 1992) 2, 3

STATUTES

11 U.S.C. § 101(5) 5

11 U.S.C. § 502(i) 5

11 U.S.C. § 507(a) 5

11 U.S.C. § 521 5

11 U.S.C. § 727(a)(3) 6

26 U.S.C. § 166 3

Cal. Evid. Code § 115 4

Cal. Rev. & Tax Code § 17201 3

REPLY TO RESPONDENT'S BRIEF

Petitioner, Franchise Tax Board of the State of California ("Petitioner") submits this reply to the Brief of Respondent, Stephen B. Macfarlane ("Respondent").

Petitioner is not requesting this Court to review evidence.

Petitioner is asking this Court to correct the erroneous rule of law applied to the evidence by the Ninth Circuit and to remand the case back to the lower court so that the correct rule of law can be applied to the evidence.

Pursuant to rule 15.6, petitioner relies upon its petition and upon the amicus brief filed by New Mexico and 23 other states to establish that there is a clear conflict in the circuits on an important federal question.

ARGUMENT

I.

RESPONDENT'S OPPOSITION CONTAINS INACCURACIES WHICH NEED TO BE CORRECTED

Statements contained in respondent's opening brief do not comport with the facts set forth in the record.

Respondent contends that the audit of the Franchise Tax Board was based upon a federal audit which the federal government abandoned. (RBO[1] at p. 2.) Respondent is in error. The record reflects that the federal government was paid $250,000 to settle their claim on this allegedly abandoned audit.

---

[1] The designation RBO refers to Respondent's Brief In Opposition.

The respondent opines that the Fourth Circuit's holding with respect to the burden of proof issue in *Landbank Equity Corp. (Internal Revenue Service v. Levy)*, 973 F.2d 264 (4th Cir. 1992) is dicta on the alleged basis that "no evidence was presented to rebut the tax claim." (RBO at pp. 2, 4.) Respondent is incorrect. In *Landbank (Levy)*, the opinion states, "given the state of the debtors' financial records '[i]t would be impossible for the Trustee to prove the time at which specific debts became worthless.' " (*Landbank*, 973 F.2d at 269.) The opinion shows that in *Landbank* the courts had the financial records presented to them but that the records were insufficient to satisfy the burden of proving the validity of a bad debt deduction.

With respect to respondent's contention regarding the *Landbank (Levy)* decision's burden or proof issue being dicta the language of the opinion itself specifically states: "[T]he sole question presented to us on this appeal is whether, in the context of a bankruptcy proceeding, the burden of showing entitlement to a deduction for bad debts shifts from the taxpayer to the IRS". (*Landbank*, 973 F.2d at 268.)

It is hard to conceive that the resolution of the sole issue presented to a federal appellate court is dicta. (See, RBO at p. 2.)

Respondent also incorrectly contends that, "[f]urthermore, *Levy [Landbank]* recognized that its decision may apply only to federal tax claims inasmuch as it distinguished *California State Board of Equalization v. Official Unsecured Creditors Comm. (In re Fidelity Holding Co., Ltd.)*, 837 F.2d 696, 698 (5th Cir. 1988). . . . " (RBO at p. 4.)

Landbank does not distinguish the Fifth Circuit case. *Landbank* cited that case with a "[b]ut see" signal, indicating that the Fifth Circuit case supported a proposition in conflict with the Fourth Circuit holding. (*Landbank*, 973 F.2d at 271.)

Respondent further contends that in the present matter no burden of proof issue was raised by the record because "no fact was controverted". (RBO at p. 5.) Here again respondent is incorrect. The record, through the admissions of the debtor at his deposition, reflects that many important facts were controverted. The record is replete with admissions contradicting the existence of the very elements necessary to establish entitlement to a valid bad debt deduction under applicable law. There was evidence raising questions as to whether a true debtor-creditor relationship existed, whether the money was an investment or loan, and whether there was a reasonable expectation of repayment. (See, Petition App. 31-34.) As a matter of law all of these factors are relevant to a determination of whether or not there were sufficient grounds for a bad debt deduction. (*26 U.S.C. § 166; Cal. Rev. & Tax Code § 17201.*) Petitioner is not asking this Court to review this evidence. Petitioner and amici states are only asking this Court to resolve the legal issue of which party has the ultimate burden of proving the validity of a tax deduction.

Finally, respondent contends that there was no burden of proof issue raised by the record because "the Petitioner never cited any applicable state standard for burden of proof which applied in the presence of such facts". Under California statutory law, judicially noticeable by any court, in litigating entitlement to a bad debt

deduction the "preponderance of the evidence" standard applies. (*Cal. Evid. Code § 115.*)[2]

II.

THE CONFLICT WITH THE FOURTH CIRCUIT'S DECISION IS NOT DISPELLED BY THE FACT THAT THE FRANCHISE TAX BOARD WAS UNABLE TO MAKE A FINAL ASSESSMENT OF MACFARLANE'S TAX LIABILITY BEFORE COMMENCEMENT OF THE BANKRUPTCY CASE

Respondent contends that no conflict exists and that there is no real issue of burden of proof because the state's proof of claim filed in the estate was not based upon a final tax assessment but only upon a proposed tax assessment which was prevented from becoming final because of the automatic stay. (RBO at pp. i, 2.)

Respondent's contention is incongruous. The Code itself gives priority status to an income tax, "not assessed before, but assessable under applicable law or by agreement, after, the commencement the case." (*11 U.S.C.*

---

[2] California Evidence Code § 115 provides in full as follows:

" 'Burden of proof' means the obligation of a party to establish by evidence a requisite degree of belief concerning a fact in the mind of a trier of fact or the court. The burden of proof may require a party to raise a reasonable doubt concerning the existence or nonexistence of a fact or that he establish the existence or nonexistence of a fact by a preponderance of the evidence, by clear and convincing proof, or by proof beyond a reasonable doubt."

"Except as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence."

§ 507(a)(8)(A)(iii).) "Claim", as defined by the Code, includes a right to payment even if unmatured and/or contingent. (*11 U.S.C. § 101(5).*) Thus the Franchise Tax Board claim was entitled to priority. A claim arising after commencement of a case for a tax that is entitled to priority under section *507(a)(8)* is to be determined and allowed as if such claim had arisen before the date of the filing of the petition. *(11 U.S.C. § 502(i).)* Clearly, unassessed taxes, which are due and owing, but not yet final, fall within the concept of "claim" for which a proof of claim may be filed. (*In re Davidson*, 156 B.R. 600, 603 (Bankr. Ark. 1993).)

Respondent's opposition provides no valid basis for the argument that no conflict with the Fourth Circuit exists because the prepetition taxes at issue had not been the subject of a final assessment before commencement of the bankruptcy proceeding.

III.

A DEBTOR IN POSSESSION OR A TRUSTEE IS ALREADY REQUIRED TO POSSESS RECORDS SUPPORTING THEIR FINANCIAL TRANSACTIONS; NO CHAOS WILL RESULT BY REQUIRING THAT THE DEBTOR OR TRUSTEE COMPLY WITH EXISTING LAW AND PROVIDE EVIDENCE CONSISTENT WITH THE PROPER BURDEN OF PROVING ENTITLEMENT TO A DEDUCTION

The Code provides that it is the debtor's duty to keep and supply accurate financial information. (*11 U.S.C. § 521.*) To require the debtor or the trustee to produce evidence proving entitlement to a bad debt deduction is

in complete accord with existing law and will impose no greater burden than currently exists.

The ability of debtors to discharge their debts is the primary benefit of the bankruptcy system. Section 727(a)(3) of the Code requires, as a precondition to discharge, that debtor or trustee produce records "from which the debtor's financial condition or business transactions might be ascertained. . . . "

Since failure of the debtor or the trustee to produce books and records will result in a debtor failing to receive a discharge, it is not disruptive when applicable substantive law imposes the burden of proof on debtors to produce sufficient books and records to establish the validity of bad debt deductions in bankruptcy claims litigation.

It should not be the task of creditors to spend endless hours gathering evidence when applicable substantive law already requires the debtor (taxpayer) to maintain sufficient records to support their tax deductions. No further policy is served by changing this requirement simply because a taxpayer has decided to file a bankruptcy petition.

Finally, in this particular case the challenge to the tax assessment was not raised by other creditors or the trustee. The dispute was solely between the State of California and the debtor, "Macfarlane", who would be the principal beneficiary of the Ninth Circuit's ruling.

CONCLUSION

The crucial importance of the issue before this Court is demonstrated by the fact that twenty-four amici states filed a brief in support of the petitioner. This Court is urged to accept this case in order to resolve a clear conflict between the circuits on this important issue.

Respectfully submitted,

DANIEL E. LUNGREN,
Attorney General of the
State of California
TIMOTHY G. LADDISH,
Assistant Attorney General
CAROL H. REHM, JR.
Supervising Deputy Attorney
General
ANTHONY SCHERZI,
Deputy Attorney General
(Counsel of Record)
Attorney for Petitioner
Franchise Tax Board of the
State of California